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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC); REVIEW OF UNITED KINGDOM, FEBRUARY 13, 1978

REFS: (A) PARIS 3347; (B) STATE 36859;
(C) LONDON 2211; (D) STATE 30018;
(E) EDR(78)2 AND ADDENDUM

1. SUMMARY: EDRC APPLAUDED UK ECONOMIC POLICY MANAGE-
MENT IN 1977, BUT DREW DISTINCTION BETWEEN TURNAROUND
ON FINANCIAL SIDE AND LACK OF PROGRESS ON REAL SIDE.
EDRC ALSO URGED CAUTION FOR 1978 LEST POLICY-MAKERS
BASK IN THE GLORY OF LAST YEAR'S ACHIEVEMENTS, WHILE
LETTING POLICY SLIP INTO OLD MISTAKES. THE OUTLOOK FOR
1978 SUGGESTS A SLOW REVIVAL OF DOMESTIC DEMAND WHILE
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THE BATTLE AGAINST INFLATION MUST CONTINUE TO BE WAGED.
EDRC CONCLUDED THAT TAX CUTS CONDITIONED ON EARNINGS
RESTRAINT WERE NOT THE BEST WAY TO ENCOURAGE WAGE MODER-
ATION, BUT THAT SOME FORM OF INCOMES POLICY WAS PROBABLY
NEEDED IN THE UK TO SUPPLEMENT TRADITIONAL FISCAL AND
MONETARY TOOLS. UK DELEGATION, LED BY ISAAC, TREASURY
UNDER SECRETARY, WAS UNWILLING TO GIVE EDRC SNEAK PRE-

VIEW OF CONTENT AND IMPLICATIONS OF COMING APRIL BUDGET. ON THE MEDIUM-TERM, THE UK DELEGATION ACCEPTED THE ADDITION OF MATERIAL FROM THE 1977 SURVEY TO "BEEF UP" THE 1978 SURVEY CONCLUSIONS ON POLICY OPTIONS FOR USING THE NORTH SEA OIL REVENUES. U.S. PRESSED UK DELEGATION ON QUESTION OF LIBERALIZATION OF OUTWARD EXCHANGE CONTROLS (REF D). MISSION APPRECIATED THE PARTICIPATION OF FINANCIAL ATTACHE AMMERMAN FROM AMEMBASSY LONDON IN THIS REVIEW OF THE UK ECONOMY. END SUMMARY

2. RECENT TRENDS: THE UK DELEGATION RECALLED THE APPREHENSION VOICED DURING THE 1977 EDRC EXAMINATION OF THE UK ECONOMY BEFORE REPORTING THAT, ON THE FINANCIAL SIDE, THINGS HAD GONE BETTER THAN COULD HAVE BEEN EXPECTED -- DUE PARTIALLY TO "EUPHORIA" IN THE EXCHANGE MARKET WITH REGARD TO STERLING. EXCEPT FOR EXPORTS WHICH WERE ALSO UNEXPECTEDLY STRONG, THE REAL SIDE DIDN'T DO SO WELL. UNEMPLOYMENT (BUT ALSO EMPLOYMENT) ROSE DURING THE YEAR, INDUSTRIAL PRODUCTION WAS STAGNANT, AND IMPORT PENETRATION, ESPECIALLY OF MANUFACTURES, WAS GREATER THAN DESIRABLE IN LIGHT OF THE NEED TO STIMULATE DOMESTIC PRODUCTION. WITH THE UNFAVORABLE PROGRESS OF THE REAL SECTOR, THE OCTOBER MINI-BUDGET WAS DESIGNED TO GIVE QUICK SUPPORT TO EMPLOYMENT WITHOUT GIVING NEW IMPETUS TO INFLATION, ASSIST THE "INDUSTRIAL" STRATEGY, AND NOT PRECLUDE FURTHER TAX STIMULUS

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IN THE 1978 BUDGET. OVERALL, THE UK DELEGATION AGREED WITH THE SECRETARIAT'S PRESENTATION OF THE 1977 OUTCOME, WHILE NOTING THAT (A) THE SHORTFALLS IN PUBLIC

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EXPENDITURES WERE NOT SURPRISING SINCE THE EXPENDITURE CEILINGS ARE LIMITS NOT NECESSARILY TARGETS; (B) THEY HAD NO EXPLANATION FOR THE EMPLOYMENT INCREASES WHICH HAD OCCURRED IN MANUFACTURING DURING A PERIOD OF STAGNANT PRODUCTION; (C) PRIVATE INVESTMENT WAS STRONG (UP 10 PERCENT).

3. OUTLOOK FOR 1978: FOR THE YEAR AS A WHOLE, THE UK DELEGATION AGREED WITH THE SECRETARIAT FORECAST (OUTLINED PARIS 3347) OF 3-1/4 PERCENT GDP GROWTH AND A \$3 BILLION CURRENT SURPLUS. THE MAJOR DIFFERENCE CONCERNED THE PROFILE FOR THE YEAR, PRINCIPALLY THE SECRETARIAT'S SHARP IMBALANCE BETWEEN THE TWO HALF-YEARS. SECRETARIAT AGREED THAT FORECAST WOULD BE REVISED TO SMOOTH OUT THE TWO HALVES (WHILE STILL SHOWING A SECOND HALF SLOWDOWN DUE TO SHARP "BLIP" IN PRIVATE INVESTMENT IN SECOND QUARTER -- "THE NORTH SEA WINDOW"), WHILE LEAVING THE FULL YEAR VIRTUALLY LIMITED OFFICIAL USE

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UNCHANGED. ALTHOUGH AGREEING ON THE \$3 BILLION CURRENT SURPLUS, THE UK DELEGATION SUGGESTED THAT BOTH EXPORTS AND IMPORTS WERE LIKELY TO BE STRONGER THAN THE SECRETARIAT EXPECTED. THEY IMPLIED THAT FORECAST FOR SIZE OF SURPLUS MIGHT TURN OUT TO BE SOMEWHAT HIGH SHOULD EXPORTS NOT BE AS STRONG AS EXPECTED, EITHER DUE TO A DETERIORATION IN UK COMPETITIVENESS OR WEAKER GLOBAL TRADE. THE UK DEL ACCEPTED THE SECRETARIAT'S ASSUMPTION OF 14 PERCENT INCREASE IN NOMINAL EARNINGS (NOT WAGES), BUT ASSERTED THAT THE PASS-THROUGH TO PRICES WOULD NOT OCCUR AS RAPIDLY AS ASSUMED BY THE SECRETARIAT, THUS LOWERING THE 1978 INFLATION RATE (CPI) TO marginally below 10 PERCENT. JEREMIAH OF TREASURY COUNTER-INFLATION GROUP CLAIMED THAT SECRETARIAT HAD SUBSTANTIALLY OVERESTIMATED THE DEGREE OF STALLING IN WAGE NEGOTIATIONS, STATING THAT RELATIVELY FEW WERE

BEHIND NORMAL SCHEDULE AND THAT 90 PERCENT OF SETTLEMENTS THUS FAR COMPLETED WERE WITHIN THE GOVERNMENT'S GUIDELINES. HE NOTED THAT THE FORD SETTLEMENT, WHILE EXCEEDING THE GUIDELINES, HAD COMPENSATING PRODUCTIVITY FEATURES AND HAD, IN ANY CASE, NOT TURNED OUT TO BE A TREND SETTER FOR THE INDUSTRY. SHEPHERD, HEAD OF TREASURY'S SHORT-TERM FORECASTING UNIT, DID NOT REVEAL A NEW OFFICIAL FORECAST, BUT GENERALLY ACCEPTED, WITH SOME DOWNSIDE PESSIMISM, THE SECRETARIAT'S PROJECTION AS CONSISTENT WITH THE UK'S CURRENT FORECAST (I.E., AFTER THE OCTOBER PACKAGE). SHEPHERD, UPON OCCASION, SEEMED TO IMPLY THAT THE APRIL 11 BUDGET WOULD DO WHAT WAS NECESSARY TO OVERCOME THE DOWNSIDE RISK IN THE CURRENT FORECAST, BUT OFFERED NO CLEAR INFORMATION ON WHAT WAS LIKELY TO BE IMPACT OF APRIL BUDGET.

4. ECONOMIC POLICY -- FISCAL: UK DELEGATION CLARIFIED
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NUMEROUS MISUNDERSTANDINGS OVER THE RECENTLY RELEASED "WHITE PAPER" ON PUBLIC EXPENDITURE BY EXPLAINING THAT THE FIGURES IN THE "WHITE PAPER" ARE SPENDING LIMITS RATHER THAN BUDGET APPROPRIATIONS, AND ARE EXPECTED TO BE UNDERSHOT. THE EXPENDITURE "SHORTFALLS" AS DESCRIBED BY THE SECRETARIAT HAD, ACCORDING TO THE UK DELEGATION, BEEN ACCOUNTED FOR IN FISCAL POLICY PLANNING. A TAX CUT SEEMS CLEARLY IN THE CARDS FOR THE 1978 BUDGET BASED ON THE STATEMENTS OF THE UK DELEGATION -- BUT THE SHAPE OF THE PACKAGE IS NOT YET SETTLED. UK DEL STRESSED THE NEED FOR TAX REFORM IN BRITAIN -- PARTICULARLY TO ELIMINATE THE SO-CALLED "POVERTY TRAP" CAUSED IN PART BY THE HIGH (34 PERCENT) INITIAL TAX RATE.

5. MONETARY: EDRC DEVOTED LITTLE TIME TO MONETARY POLICY, BUT DID AGREE THAT ANY RECOMMENDATION OF GREATER FLEXIBILITY IN MONETARY TARGETS SHOULD BE CLEARLY AND UNAMBIGUOUSLY PRESENTED AS A TECHNICAL RECOMMENDATION AND NOT A CALL FOR FLEXIBILITY IN THE SENSE OF A SOFTER OR LOOSER MONETARY POLICY. RESPONDING TO A QUESTION, THE UK DEL REPORTED THAT APPROXIMATELY HALF OF THE SHORT-TERM CAPITAL INFLOW (DOLLARS) HAD BEEN STERILIZED BY THE MONETARY AUTHORITIES DURING 1977.

6. EXCHANGE RATE POLICY AND CAPITAL CONTROLS: UK DELEGATES NOTED THAT THE AUTHORITIES HAD RELUCTANTLY ABANDONED THE POLICY OF PEGGING STERLING TO A BASKET OF FOREIGN CURRENCIES IN NOVEMBER, WHEN AN INSURMOUNTABLE CONFLICT AROSE BETWEEN EXCHANGE RATE AND MONETARY POLICIES. AS A RESULT, PRICE COMPETITIVENESS HAD

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DETERIORATED BY EARLY 1978, TO EARLY 1976 LEVELS, ALTHOUGH COST COMPETITIVENESS HAD LOST CONSIDERABLY LESS GROUND. UK DELEGATION ACKNOWLEDGED THE BENEFICIAL EFFECTS OF A STRONGER POUND ON HOLDING DOWN DOMESTIC COSTS. NEVERTHELESS, PROFIT MARGINS IN THE EXPORT SECTOR, WHICH HAD WIDENED IN 1976 AND 1977, WERE BEING REDUCED. IN REPLY TO A U.S. QUESTION (BASED ON REF D) ON WHETHER UK WOULD NOT BE WELL ADVISED TO CONSIDER SUBSTANTIAL LIBERALIZATION OF OUTWARD CAPITAL CONTROLS TO REDUCE UPWARD PRESSURE ON STERLING, THE UK DELEGATION CONTENDED THAT IN PRACTICE CAPITAL OUTFLOWS WOULD BE MINOR WHEN STERLING WAS STRONG, WHEREAS WHEN STERLING WAS WEAK, MAJOR OUTFLOWS WOULD LIKELY OCCUR, CONTRIBUTING FURTHER TO SUCH WEAKNESS. THIS ASYMMETRY, PLUS THE FACT THAT FREER CAPITAL OUTFLOWS WERE CONTROVERSIAL (READ TUC OPPOSITION) ARGUED FOR GREAT CAUTION IN WEIGHING THE LIBERALIZATION OPTION. NO EARLY ACTION WAS LIKELY. ON DISCRIMINATION IN FAVOR OF THE EUROPEAN

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COMMUNITY, THE UK DEL STATED THAT THE TWO RECENT LIBERALIZATIONS OF CAPITAL CONTROLS WERE CONSISTENT WITH ALL OF UK'S INTERNATIONAL COMMITMENTS, BOTH IN OECD AND EEC, AND MOREOVER THAT THE MAJOR CHANGE (REMOVAL OF THE 25 PERCENT RULE) WAS NON-DISCRIMINATORY. ON FOREIGN DEBT REPAYMENT, UK AUTHORITIES INTEND TO SPREAD THE APPROXIMATELY \$20 BILLION DUE BETWEEN 1978 AND 1984 BY SELECTED PREPAYMENT AND REFINANCING, BUT DO NOT BELIEVE THAT DEBT REPAYMENT OPERATIONS WILL HAVE A SIGNIFICANT EFFECT ON THE EXCHANGE RATE, IF PROPERLY MANAGED.

7. INDUSTRIAL POLICY: NUMEROUS QUESTIONS FROM DELEGATIONS (INCLUDING THE U.S.) ON THE "NEW INDUSTRIAL STRATEGY" RESULTED IN THE PROPOSED ADDITION OF AN ANNEX TO THE UK SURVEY WHICH WILL GIVE DETAILS ON THE PRESENT STATE OF THE PROGRAM, ITS INTENTIONS AND RELATED EXPENDITURES TO DATE. AS DESCRIBED BY THE UK DELEGATION, THE STRATEGY IS BASED ON TRIPARTITE SECTORAL STUDY GROUPS WHICH ARE INTENDED TO DEVELOP PLANS TO RESTRUCTURE AND RATIONALIZE THE PRODUCTIVE CAPABILITY OF THE SECTOR. ACTION PLANS WILL "TRICKLE UP" TO RECEIVE ASSISTANCE FROM GOVERNMENT AND "TRICKLE DOWN" TO GUIDE INDIVIDUAL DECISION-MAKERS AT THE ENTERPRISE LEVEL. UK DEL FELT THAT SPECIFIC SECTORAL SUPPORT WAS NECESSARY TO ANTICIPATE AND ELIMINATE BOTTLENECKS WHICH COULD THWART A SUSTAINED ECONOMIC RECOVERY. ISAAC CITED THE NON-EXISTENCE OF A "GRAND PLAN" AS THE ASSET WHICH DISTINGUISHES THE PRESENT "STRATEGY" FROM EARLIER COMPARABLE PROGRAMS. IN THE MEDIUM-TERM, RESTRUCTURING UNDER THE INDUSTRIAL STRATEGY IS SEEN AS THE KEY TO RESTORING BRITISH COMPETITIVENESS, BOTH ON PRICE AND NON-PRICE (QUALITY, TECHNOLOGY, SERVICE, MARKETING, ETC) LIMITED OFFICIAL USE

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GROUPS.

8. INCOMES: THE SECRETARIAT'S PROPOSED CONCLUSION THAT TAX CUTS SHOULD BE EXPLICITLY CONDITIONAL ON WAGE MODERATION SPARKED A LIVELY DISCUSSION OF THE INS AND OUTS OF INCOMES POLICY. JEREMIAH STATED THAT THE UK AUTHORITIES HAD CONCLUDED THAT EXPLICIT OFFERS OF TAX CUTS IN EXCHANGE FOR WAGE MODERATION WERE NOT SUCCESSFUL, AND WERE AT TIMES COUNTER-PRODUCTIVE. TAX CUTS DID, HOWEVER, PROVIDE A MORE CONDUCIVE ATMOSPHERE IN WHICH TO CONDUCT WAGE NEGOTIATIONS. PUTTING IT DIFFERENTLY, HE ALSO CLAIMED THAT TRADITIONAL FISCAL AND MONETARY POLICY WOULD NOT HAVE BEEN SUFFICIENT TO BRING ABOUT THE EARNINGS DECELERATION EXPERIENCED UNDER PHASE I AND II. THE

UK HAS HAD AN INCOMES POLICY DURING 13 OF THE LAST 17 YEARS, HE ADDED, AND EACH TIME IT WAS SUSPENDED, AN EARNINGS EXPLOSION OCCURRED. THIS SERIES OF EVENTS LED TO THE CURRENT THINKING THAT A PERMANENT ARRANGEMENT WAS NECESSARY TO INSURE THAT EARNINGS TRENDS WOULD BE CONSISTENT WITH GENERAL ECONOMIC OBJECTIVES, PERHAPS THROUGH A LONG-TERM AGREEMENT WITH THE TUC ON ACCEPTABLE PROCEDURES FOR WAGE NEGOTIATIONS. ON THE PHASE III ARRANGEMENTS, JEREMIAH CONTENDED THAT THE TUC HAD GIVEN ITS TACIT CONSENT TO TWO KEY POINTS (I.E., 12-MONTH INTERVAL AND THE 10 PERCENT GUIDELINE), ADDING THAT THE GOVERNMENT COULD NOT PURSUE AN INCOMES POLICY WITHOUT THE CONSENT OF THE TUC. RESPONDING TO A QUESTION ON THE

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EFFICACY OF SANCTIONS AGAINST BUSINESS FOR BREACHING INCOMES POLICY GUIDELINES, JEREMIAH COMPARED SANCTIONS TO THE NUCLEAR DETERRENT, I.E., "IF YOU HAVE TO USE IT, IT HASN'T WORKED, AND YOU HAVE A BIG MESS TO CLEAN UP."

9. ON THE MEDIUM-TERM: THE U.S. DEL MADE A STRONG AND SUCCESSFUL BID FOR "BEEFING UP" THE DRAFT SURVEY WITH

ADDITIONAL LANGUAGE ON THE DESIRABLE CHOICE BETWEEN THE
VARIOUS MEDIUM-TERM OPTIONS OPEN TO THE UK AUTHORITIES
-- DRAWING ON THE ANALYSIS OF THE 1977 SURVEY. ISAAC
ALSO OUTLINED SEVERAL POINTS WHICH WOULD BE INCLUDED IN
THE UPCOMING WHITE PAPER ON USES OF NORTH SEA OIL
REVENUES, NAMELY THAT:

-- NORTH SEA OIL REVENUES, ALTHOUGH SIZEABLE IN
ABSOLUTE TERMS, WERE SMALL RELATIVE TO THE GOVERNMENT
BUDGET (FOR TAX RECEIPTS) AND TO GNP AND THE CURRENT
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ACCOUNT (FOR FOREIGN EXCHANGE EARNINGS) AND MUST THERE-
FORE BE KEPT IN PERSPECTIVE.

-- THE INCOME SHOULD NOT BE USED FOR A QUICK
INCREASE IN CONSUMPTION.

-- THE EVIDENT NEED FOR GREATER INVESTMENT SHOULD BE
A PRIORITY USE FOR WHICH CONTROLLING INFLATION AND
PRUDENTLY EXPANDING DOMESTIC DEMAND WERE PRECONDITIONS.

-- THE TAX BURDEN SHOULD BE REDUCED.

-- MODERATE INCREASES IN GOVERNMENT EXPENDITURES
SHOULD BE PROGRAMMED TO INSURE THAT THE "WINDFALL"
AIDED DISADVANTAGED SEGMENTS OF THE POPULATION, BUT
THAT THE PUBLIC SECTOR SHOULD NEVERTHELESS GROW LESS
RAPIDLY THAN GDP.

10. CONCLUSIONS: THE EDRC EXAMINATION OF THE UK
ECONOMY PRODUCED A NUMBER OF PROBING QUESTIONS FROM
VIRTUALLY ALL MEMBER DELEGATIONS AND A VAST QUANTITY OF
WORDS FROM THE UK DELEGATION IN REPLY. UNFORTUNATELY,
THE DETAIL OF REVELATION, BOTH IN POLICY AND STATISTICAL
TERMS, DID NOT MATCH THE QUANTITY OF WORDS. THE UK
DELEGATION DID NOT EVEN HINT, FOR EXAMPLE, THAT
JANUARY, 1978 TRADE DEFICIT WHICH WAS ANNOUNCED THE
FOLLOWING MORNING MIGHT BE DISAPPOINTING -- ALTHOUGH
MUCH OF THE DISCUSSION CENTERED ON UK COMPETITIVENESS
AND THE BOP OUTLOOK FOR 1978. NEVERTHELESS, IN BROAD
TERMS THE DISCUSSION WAS USEFUL AND THE EDRC WAS ABLE
TO REACH THE FOLLOWING CONCLUSIONS:

(1) THE UK AND SECRETARIAT ARE AGREED ON A COMMON
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FORECAST FOR 1978, WITH SOME MODIFICATION OF THE SECRETARIAT'S GROWTH PROJECTION TO SMOOTH THE PROFILE.

(2) PRUDENCE AND CAUTION MUST BE THE KEY WORDS IN ECONOMIC POLICY FORMULATION FOR 1978. OUTCOME OF 1977 MUST BE VIEWED "WITH RELIEF," BUT UK CANNOT BASK IN THE GLORY OF 1977 ACCOMPLISHMENTS, RATHER CONTINUE WITH A PRUDENT POLICY TO SLOWLY STIMULATE THE "REAL" ECONOMY WHILE HOLDING INFLATION IN CHECK. SPECIFICALLY, THERE IS ROOM FOR BUDGET STIMULUS, IN CONJUNCTION WITH SOME FORM OF INCOMES POLICY, BUT PERHAPS NOT A "CONDITIONAL TAX CUT" AS PROPOSED BY SECRETARIAT. MONETARY POLICY MAY BECOME MORE FLEXIBLE IN TECHNICAL TERMS, BUT THE RESOLUTION TO MEET CAUTIOUS TARGETS ONCE SET MUST REMAIN FIRM.

(3) INCOMES POLICY, IN WHATEVER FORM, MUST BE ORIENTED TOWARD HOLDING DOWN NOMINAL WAGES, THUS IMPROVING THE COST SITUATION FOR UK PRODUCERS.

(4) IN THE MEDIUM-TERM, THE REDRAFTED SURVEY WILL DRAW FROM THE 1977 SURVEY TO OUTLINE, WITH APPROPRIATE MODIFICATIONS, THE DESIRABLE CHOICE AMONG THE OPTIONS ON USE OF NORTH SEA RESOURCES. ON PRICE AND NON-PRICE COMPETITIVENESS, THE EDRC LOOKS FORWARD TO AN OPPORTUNITY TO EVALUATE THE SUCCESS OF THE "NEW INDUSTRIAL STRATEGY" IN RESTRUCTURING BRITISH INDUSTRY TO MEET, IN AN EFFICIENT MANNER, COMPETITION FROM ABROAD.
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